TheTotal Return Approach to Trust Investment Management

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Early History

The *Oxford English Dictionary* states that the word "endowment" dates from the fifteenth or sixteenth century. In fact, as early as the twelfth century, land was donated as a perpetual support for ecclesiastical organizations. According to Ennis and Williamson, this land-based funding source is important in explaining the traditional approach to spending policy. Land generates rental income for the endowed institution. But both land values and income tend to rise over time, enabling the institutions to "cope not only with rising costs but with expanded activities as well." In this context it made sense to spend "income" but preserve "principal." By the 1800s, the Church of England had accumulated so much endowed wealth that the British Parliament legislated spending restrictions on the church.[1]

However, by the late 19th century, most institutions were endowed not with land but with bonds and mortgages – "fixed return investments." The built-in inflation hedge of the land endowment had vanished. According to Ennis and Williamson, "preservation of capital meant preservation of 'book value', not preservation of purchasing power or *real* value."[2]

The first foray into equities had not gone well. In 1719, the British Parliament approved the purchase of shares in the South Sea Company by English trustees. Unfortunately, the company folded a year later, causing huge losses. Parliament responded by issuing a list of "safe" trust investments (mostly government bonds). Equities were not to be added again for 140 years.[3]

The above prejudice passed into American law in 1830. Judge Samuel Putman presided in the case of *Harvard College vs. Amory*. In that case, the Supreme Court of Massachusetts issued the *prudent man rule*: "Those with responsibility to invest money for others should act with prudence, discretion, intelligence, and regard for the safety of capital as well as income." There was no requirement for trustee expertise, but there was the requirement for the avoidance of risk. Later court decisions extended the principle to individual investments. Good overall portfolio results did not excuse a single bad investment decision. To clarify what it meant to be prudent, courts and state legislators created lists of acceptable investments. On these "legal lists" bonds were deemed prudent and stocks were considered speculative. Other types of investments were classified according to the belief system of those doing the classifying. The point is that each investment was considered on its own merit. There was no attempt to integrate investments into a coherent portfolio. [4]

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[1] Richard M. Ennis and J. Peter Williamson, *Spending Policy For Educational Endowments*, (Westport, CT: The Common Fund, January 1976): 6

[2] Ennis and Williamson : 7

[3] Kevin Coventon, " Prudent Investors, New Rules for Centuries-Old Problem", *Non Profit Times* (2001).

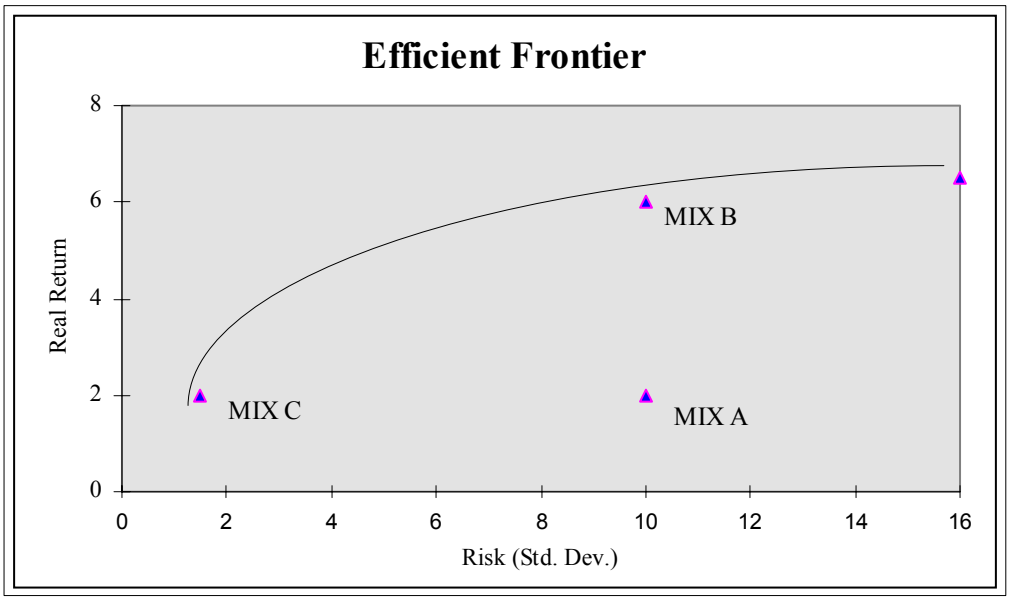
[4] Coventon

The Modern Era

In 1952 a young graduate student named Harry Markowitz published his doctoral thesis on the diversification of portfolios. In his thesis and in his 1959 book *Portfolio Selection: Efficient Diversification of Investments* he outlined what came to be known as Modern Portfolio Theory (MPT). Using the first computers to analyze daily transaction records going back to 1926 researchers had made a startling discovery. Market returns were normally distributed (actually log-normal distributions). This meant that robust statistical tools could be applied. This was a watershed event. Markowitz' mathematical model became the bedrock of financial management. In 1990 he shared the Nobel Prize in economics for that work.

MPT is based on several assumptions. First, that risk and return are linked; more volatile investments tend to produce higher return over time. Secondly, rational investors seek to maximize return at each given risk level. Thirdly, the risk and return of a single investment are immaterial. What counts is the impact that each investment has on the total portfolio (its correlation coefficient). By combining investments with low correlation to each other, one could create a portfolio that was less risky than any of its components. Finally, central to Modern Portfolio Theory is the idea that a dollar of income is equal to a dollar of growth – **the total return concept.** In fact, it is impossible to optimize for anything other than total return.

The Markowitz model calculates an *efficient frontier*, the arc describing the highest returning portfolio at each risk level.



An investor in mix A (100% long-term bonds) would probably prefer mix B (a balanced mix of stocks, bonds and cash - same risk, triple the expected real return above inflation). Or, if the investor could live with the return of mix A, he or she would probably prefer mix C (mostly cash instruments, some stocks, and bonds - same return, almost no risk). Mix A is inefficient the other two mixes are more efficient.

The Legal Challenge

By 1969 it had become widely recognized that traditional approaches to the management of endowed funds (e.g. spending "income only") were less than optimal. However, trustees were afraid to veer from those sub-optimal practices because of the perceived risk of litigation under existing trust law. So, in that year the Ford Foundation commissioned two reports. The first report, by law professor William L. Cary and Craig B. Bright, Esq. argued that trust law (the prudent man rule) did not apply to endowed funds.

Under traditional trust law there are typically two parties with conflicting interests: (1) *the income recipient* who would prefer to maximize current income at the expense of future growth and (2) *the remainderman* who receives the proceeds of the trust upon death of the income recipient. The remainderman's interest, of course, would be to maximize future growth rather than current income. Trust law existed to protect the interest of both parties… "spend income, preserve principal."

However in the case of a typical endowed fund there is only one party. The fund fiduciaries must balance the current spending needs with the requirement for future spending, taking into account the loss of purchasing power caused by inflation. Cary and

Bright argued that the more applicable law was that which governs corporations. Under corporate law realized gains are clearly part of the income of the corporation.[5]

The Barker Report

The second Ford Foundation report, *Managing Educational Endowments*, also known as the Barker Report (after the chairman of the committee, Robert R. Barker,) was even more compelling. The advisory committee analyzed the investment results of fifteen large educational endowments and compared their performance to that of twenty one randomly selected balanced funds, ten large growth funds, and the endowment of the University of Rochester; the results were dismal. The table below summarizes their findings.

1959-68 Total Return

	Cumulative	**Annual Average**
Fifteen educational institutions—average	134%	8.7%
Twenty one balanced funds—average	143	9.2
The University of Rochester	283	14.4
Ten large general growth funds--average	295	14.6

The authors wrote, " What is the explanation for so striking a contrast? We believe the fundamental reason is that trustees of most educational institutions, because of their semi-public character, have applied a special standard of prudence to endowment management which places primary emphasis on avoiding losses and maximizing present income. Thus the possibility that other goals might be reasonable--and perhaps even preferable—has hardly been considered…" The Barker report went on to recommend that educational endowments adopt the *total return approach*, that a "small portion of realized gains may be used to supplement interest and dividends for operating purposes…" Furthermore the advisory board recommended that the management of those funds be delegated to professional money managers.[6] Following this report, most large university endowment began to adopt the total return approach.

UMIFA

In 1972 the National Conference of Commissioners on Uniform State Laws recommended the adoption of the *Uniform Management of Institutional Funds Act (UMIFA).* This act sought to codify the findings of the two Ford Foundation reports. As the Conference authors wrote in the preface to the act,

> "Over the past several years the governing boards of eleemosynary institutions, particularly colleges and universities, have sought to make more effective use of endowment and other investment funds. They and their counsel have wrestled with questions as to permissible investments, delegation of investment authority and the use of the total return concept in investing endowment funds."

[5] William L. Carey, Craig B. Bright, esq., *The Law and Lore of Endowment Funds,* The Ford Foundation 1969

[6] *Managing Educational Endowments,* The Ford Foundation, 1969

The act specifically provided:

1. A standard for prudent use of appreciation in invested funds;
2. Specific investment authority;
3. Authority to delegate investment decisions;
4. A standard of business care and prudence to guide governing boards in the exercise of their duties under the Act; and
5. A method of releasing restrictions on the use of funds or selection of investments by donor acquiescence or court action.[7]

Since that time UMIFA has been adopted by all but a handful of states.

ERISA

In 1974 Congress passed *The Employees' Retirement Income Security Act* (ERISA). This act established a higher standard for fiduciaries of retirement plans, that they act with the "care and skill of a prudent person, *familiar with such matters*…" (emphasis added). Congress incorporated many of the tenets of Modern Portfolio Theory. These include the reliance on a prudent process (rather than outcome) and the mandate to diversify.[8]

The Prudent Investor Standard

The Uniform Prudent Investor Act of 1994 had been adopted by 34 states as of February 15, 2001. According to Coventon "The significance of the rule change is easily expressed by the change from a focus on a 'prudent man' or 'prudent person' to a focus on a more experienced 'prudent investor.' The act specifically instructs investors to make investment decisions in the "context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[9]

UPIA

Applying the principals of UMIFA to the oversight of other trusts, the National Conference of Commissioners on Uniform State Laws adopted the *Uniform Principle and Interest Act of 1997.* This act explicitly is designed to allow trustees to make investment decisions on a total return basis. Specifically, trustees can allocate receipts between income and capital accounts to achieve "even-hand" objectives. The act also explicitly adopts the Modern Portfolio Theory framework as the appropriate approach to the oversight of trust assets. [10] This act has been adopted by over two dozen states, including North Dakota.

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[7] *Uniform Management of Institutional Funds Act,* National Conference of Commissioners on Uniform State Laws, August 4-11, 1972

[8] *The Employees' Retirement Income Security Act,* 1974

[9] Kevin Coventon, " Prudent Investors, New Rules for Centuries-Old Problem", *Non Profit Times* (2001).

[10] *Uniform Principle and Interest Act of 1997,* National Conference of Commissioners on Uniform State Laws

In addition, all 50 states now allow the creation of "total return trusts." These trusts pay out a percentage of trust assets on a yearly basis rather than "income". As of April 8, 2002, four states had passed laws allowing existing irrevocable trusts to convert (with the consent of the beneficiary) to total return trusts.

The Case for the Total Return Approach

As outlined in the above brief history, the thrust of academic theory, federal law, and state law has been a movement toward a total return spending policy. There are several compelling reasons for such an approach:

1. A rational investor would choose to maximize return and minimize risk. The artificial distinction between income (dividends and interest) and principal forces an "income only" investor into inefficient portfolios (lower expected return at the same risk level). That is, the need to spend income forces one toward a larger and larger percentage of income producing securities even as the purchasing power of that income shrinks due to inflation.
2. The artificial distinction further forces fiduciaries into short term decisions that may be contrary to the long term good. I.e., maximizing current income is often antithetical to the real goal of creating an ever-increasing income stream and principal value. To accomplish that objective there must be sufficient growth in the portfolio—and a mechanism to harvest that growth.
3. Asset allocation should drive spending, rather than the reverse. If a given asset allocation has an expected return of say 8%, one could justify spending 4.25% knowing that even with that spending level, the portfolio should grow in real terms (assuming that inflation is below 3.75%). On the other hand, the large fixed income allocation generated by the "income only" approach can ultimately lead to reduced future principal and spending in real terms—exactly the opposite effect from that intended.
4. Another unintended consequence of the "income only" approach is that it forces yield-hungry investors toward riskier investments. They'll invest in bonds with longer duration (which suffer worse declines in a rising interest rate environment), lower credit quality, or prepayment risk (mortgage backed securities).
5. The total return approach can smooth spending during times when available yields in the marketplace become low. Such a policy avoids undue, and unnecessary, hardship for the beneficiaries of the trust. For example, a portfolio with an expected 8% return might adopt a policy of spending 4.25% of the five year average year-end balance. Half the time, returns would likely be above the 8% target and half the time returns might be below the target. But over long periods of time the fund would be expected to grow 3.75% above the spending rate. In other words, over long periods of time spending would grow by 3.75%.

   Furthermore, the five-year averaging would smooth the effect of temporary market declines. Additionally, the fund could be more broadly diversified once it was freed from the constraints imposed by the pursuit of "income." Broader diversification generally has led to smoother total return experience.

Although, as the disclaimer reads, past performance is no guarantee of future results.

6. The total return approach facilitates rebalancing efforts. Such an approach makes it possible to profit from inevitable cycles in the capital markets. Sometimes stocks outperform, sometimes bonds, sometimes small stocks etc. If one can freely rebalance, one can harvest the gains from the winning asset class and rebalance to the underperformers (which turn into the winners in the next phase). By employing such rebalancing methods, an investor not only keeps the risk profile of the portfolio constant but also has been able to add excess return.

Potential negatives

- Fund fiduciaries need to be cautious in the asset allocation process. The portfolio must be optimized to control risk, not merely to seek the highest expected return.
- During periods of strong market performance, the fund must avoid the temptation to spend the "extra" return. Markets are mean-reverting; above-target returns must be banked for the inevitable below-target period which will follow.
- Once the focus is shifted to total return, there is a natural human tendency to change strategy at inopportune times. That is, most people want to "sell out" at market bottoms and "buy in" at peaks (that is what creates peaks and bottoms.) Therefore, one must adopt a well-reasoned investment and spending policy and avoid reactive decisions.

Summary

Based on academic research and current best practices, most large funds have adopted a total return approach to the prudent investment of trust assets. This paper concurs in that recommendation. The following tables summarize important landmarks leading to that recommendation.

Early History

Year	Landmark Event	Spending Policy
12th Century	First Land Endowments	Spend "Income Only"
1720	First "Legal Lists" - Britain	Spend "Income Only"
1830	Prudent Man Rule	Spend "Income Only"
Late 19th Early 20th Century	"Legal Lists" of Acceptable Investments	Spend "Income Only"

Modern Era

Year	Landmark Event	Spending Policy
1952	First Academic Research Beginning of Modern Portfolio Theory	Total Return
1969	First Ford Foundation Report challenges the legal basis for applicability of trust law to endowed funds	Total Return
1969	The Barker Report analyzes performance and espouses a move toward a Total Return Spending/Investment Policy	Total Return
1972	*The Uniform Management of Institutional Funds Act* codified the Ford Foundation Reports and since has been adopted by most states	Total Return
1974	*The Employees' Retirement Income Act* (ERISA) was passed by Congress to establish a higher standard for retirement plan fiduciaries	Total Return
1994	*The Uniform Prudent Investor Act of 1994* shifted the focus from the "prudent man" to the "prudent investor"	Total Return
1997	*The Uniform Principle and Interest Act of 1997* was designed to permit trustees to make investment decisions on a Total Return basis	Total Return